No. 86-44

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

SHEARSON/AMERICAN EXPRESS INC. and
MARY ANN MCNULTY,

Petitioners,

v.

EUGENE MCMAHON, JULIA MCMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS

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COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. Whether a Purchaser of Securities May Be Compelled to Relinquish Substantive Federal Statutory Rights to Judicial Review and Trial By Jury of Claims Asserted Under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78a *et seq.* (1982) (the "1934 Act"), in Contravention of: the Jurisdictional and Antiwaiver Provisions of the 1934 Act; the Clear Intent of Congress; the Unbroken Line of Precedents of This Court; and Overriding Public Policy Concerns?

2. Whether Claims Asserted Under the Racketeer Influenced And Corrupt Organizations Act, 18 U.S.C. Section 1961 *et seq.* (1982) ("RICO") May Be Enforced in Other Than a Judicial Forum in Light of Legislative Intent and Legitimate Public Policy Concerns?

RULE 28.1 LIST OF PARTIES

See Petition at ii-iii; Brief for Petitioners at ii.

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BRIEF FOR RESPONDENTS

OPINIONS BELOW

See Brief for Petitioners at 1.

JURISDICTION

See Brief for Petitioners at 2.

COUNTERSTATEMENT OF THE CASE

This action was brought by Eugene McMahon and Julia McMahon individually and on behalf of various trusts, The David J. Hodder & Son, Inc. Employee Pension Plan, The David J. Hodder & Son, Inc. Profit Sharing Plan, The Laurie Funeral Home, Inc. Employee Pension Plan and the Laurie Funeral Home Profit Sharing Plan (the "trusts") (collectively

"respondents"), against Shearson/American Express, Inc., the predecessor of petitioner Shearson Lehman Brothers Inc. ("Shearson"), a brokerage firm registered with the Securities and Exchange Commission, and against Mary Ann McNulty ("McNulty") (collectively "petitioners"), a registered representative, employee and vice president of Shearson. Shearson and McNulty were responsible for respondents' accounts during the time period referred to in the amended complaint (R. 11).

The amended complaint alleges in essence that petitioner McNulty, with the knowledge and consent of petitioner Shearson: engaged in the fraudulent and wilful churning, or practice of trading excessively solely to maximize commissions, not only of respondents' individual accounts, but also of the fiduciary accounts; intentionally and recklessly violated Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. Section 78j(b) (the "1934 Act") and SEC Rule 10b-5, 17 C.F.R. Section 240.10b-5, promulgated thereunder, by making false statements and omitting material facts in the advice and financial projections given to respondents; fraudulently dissipated the funds of respondent Julia McMahon and those of numerous other investors representing the general public in a scheme known as the "Golden Apple" investment fund; and violated the provisions of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. Section 1961, *et seq.* ("RICO") (R. 11). The amended complaint also alleges pendent common law claims of fraud, misrepresentation and breach of fiduciary duty (R. 11).

Respondents claim as a first count multiple acts of fraudulent, inappropriate and excessive trading on the part of petitioners in connection with the joint account of the individual respondents, in which, for example, over 400 options were allegedly traded with commissions totalling approximately $50,000. Respondents also allege claims of securities fraud by petitioners in relation to the four trust accounts named as parties herein, where over 3,500 option trades enabled petitioners to reap overall more than $200,000 in excessive commissions (R. 11). These options trades were not in accordance with respondents' stated conservative investment objectives, and were not suited to secure either the McMahon's or their employees' retirement objectives (R. 11).

The individual respondents, who are by trade funeral home directors, were unsophisticated in the securities field, having no college degrees nor financial industry acumen and no prior investment experience in anything more risky than, *e.g.*, municipal bonds, treasury bills and money market accounts. Petitioners, who actively sought and obtained complete discretion in the handling of these accounts, failed to disclose to these unsophisticated investors the volatility of the markets in which petitioners were risking respondents' personal investment funds, and the funds of the four pension trusts as alleged. The representations made by petitioners to respondents as asserted in the amended complaint, of a guarantee of appreciation through conservative investment policies, did not come to fruition. Indeed, the gravamen of the amended complaint is that the practices of petitioners caused substantial losses (R. 11).

The third count of the amended complaint alleges a scheme by petitioners to defraud respondent Julia McMahon and to utilize her good name in recruiting members of the general public to similarly invest in the so-called "Golden Apple" investment fund, where the dissipation of substantial investments was caused by the injudicious trading of options by petitioners (R. 11). The fourth, RICO count is pleaded on behalf of all respondents. It seeks treble damages for the underlying predicate offenses which comprise a pattern of illegal conduct allegedly aimed at defrauding the respondents and the general public (R. 11).

The course of the proceedings below began when respondents filed their complaint on or about May 11, 1984 (R. 1). Petitioners vigorously contested this matter for almost one year prior to bringing on their motion to compel arbitration which was the subject of the appeal below. On July 13, 1984, petitioners filed a notice of motion to dismiss the complaint (R. 4,5). Petitioners also filed their notice to take the depositions of the individual respondents (R. 6), however, no discovery took place because following the filing of an amended complaint by stipulation (R. 11), petitioners filed yet another motion to dismiss the amended complaint on January 14, 1985 (R. 12,13). During

the pendency of petitioners' second motion to dismiss, petitioners moved to compel arbitration of respondents' claims on April 15, 1985 (R. 17, 19), almost one year after the original complaint had been filed, and after petitioners had vigorously defended the lawsuit in the judicial forum during the lengthy period following the service of the original complaint.

Respondents, it should be emphasized, in opposition to the motion to compel, have never conceded that the purported customer agreements petitioners allege they signed are either valid, enforceable or represent a knowing waiver of their right to a judicial forum under the securities laws (R. 21, 22). After the district court compelled arbitration of all but the RICO claims, which were placed on its suspense docket (R. 25), respondents appealed to the United States Court of Appeals for the Second Circuit (R. 27). Petitioners cross-appealed the district court's denial of their motion to arbitrate respondents' RICO claims (R. 28).

On April 16, 1986, the Second Circuit affirmed in part and reversed and remanded in part, holding that the district court should not have departed from the rationale and policy considerations underlying this Court's earlier decisions and Second Circuit precedent in granting petitioners' motion to compel arbitration of 1934 Act claims (R. 40,41). The Second Circuit affirmed the district court's denial of petitioners' motion to compel arbitration of the RICO claims and the lower court's direction as to arbitration of respondents' state law claims (R. 40,41).

SUMMARY OF ARGUMENT

The Second Circuit Court of Appeals held unenforceable a pre-dispute customer/brokerage agreement to arbitrate claims arising under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. Section 78j(b) and Rule 10b-5, 17 C.F.R. 240.10b-5, based upon congressional intent embodied in the statute, its legislative history, significant public policy concerns and over thirty years of judicial precedent.

Eight Circuit Courts of Appeals have followed and applied the precedent of the Supreme Court established in *Wilko v. Swan*, 346 U.S. 427 (1953), in acceding to Congress' intent that agreements to arbitrate claims asserted under the 1934 Act are stipulations waiving compliance with the substantive provisions of the statute including Section 27, 15 U.S.C. Section 78aa, which provides for exclusive federal jurisdiction. These decisions are consonant with the holdings of this Court, which have consistently recognized the continuing vitality of the *Wilko* rationale and the right of action under Section 10(b) and Rule 10b-5. The Court has deemed those rights to be as important as the right of action under Section 12(2) of the Securities Act of 1933, 15 U.S.C. Section 77l(2) (the "1933 Act"). Congress' intent to preclude enforcement of arbitration agreements that prospectively waive the judicial forum is as applicable to the 1934 Act as it is to the 1933 Act.

Broad questions of policy inherent in securities law claims mandate a judicial forum, with its attendant procedural and substantive safeguards, for the resolution of such statutory disputes in order to protect fully the rights of public customers. The adequacy of the arbitral forum to vindicate such fundamental rights, an issue raised by petitioners and the Securities and Exchange Commission as *Amicus Curiae*, has been severely criticized just recently by congressional investigative studies and hearings. The 99th and 100th Congress' current inquiry into financial market manipulation and insider trading abuses is motivated in large measure by the same policies that informed the enactment of the securities laws, and the *Wilko* case and its progeny: the protection of the public investor in the securities markets.

The self-regulatory regime that governs the financial markets has also come under congressional scrutiny to determine if, in fact, the system works. Although oversight authority is represented by the proponents of arbitration as a virtual guarantee of the adequacy and effectiveness of arbitral procedures in use at the self-regulatory organizations, this claim is subject to the Court's scrutiny, since the legislative evidence

strongly suggests that arbitration is inadequate to vindicate the public's rights under the federal securities laws.

Respondents, as public customers of the securities industry, are consumers in the financial markets whose fundamental rights under the securities laws are at risk by virtue of prospective waivers of the judicial forum. Congress, by providing public customers with statutory antiwaiver provisions, thereby intended to prohibit arbitration of claims asserted under Section 10(b).

Similarly, the nonarbitrability of claims asserted under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. Section 1961 *et seq.* ("RICO"), is evident in the statute itself and its legislative history. The parallel to the antitrust laws and the private attorney general model that governed Congress' enactment of RICO make enforcement of RICO

> "particularly appropriate in a judicial forum because of strong policy concerns, the need for development of the record, and judicial clarification and resulting consistency in resolving disputes under this relatively new statute."

McMahon v. Shearson/American Express, Inc., 788 F.2d 94, 98 (2d Cir. 1986).

Both the remedial and deterrent purposes of civil RICO were envisioned by Congress as necessary to effectuate its goal of combating organized criminality as it touches upon both legitimate and illegitimate businesses. To the extent that this Court found in *Sedima, S.P.R.L. v. Imrex*, ____ U.S. ____, 105 S.Ct. 3275, 3284 (1985), that § 1964(c) of RICO is quasi-criminal in nature, requiring the procedural and substantive due process protections typically associated with criminal proceedings, a judicial inference of Congressional intent to bar the arbitration of RICO's express rights of action is warranted.

ARGUMENT

I. The Countervailing Federal Policies Inherent in the 1934 Act, and Congressional Intent Underlying the Enactment of Its Remedies, Compel an Exception to the Federal Arbitration Act

A. The Text and Legislative History of the 1934 Act Make Unenforceable Pre-dispute Agreements to Arbitrate Claims Arising Under the Act

This case presents to the Court a significant question, apparently one of first impression, as to whether a public customer may be compelled by members of the brokerage industry to relinquish substantive federal statutory rights to judicial review and trial by jury of claims asserted under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j(b) (the "1934 Act") by virtue of a pre-dispute waiver which is in contravention of: the jurisdictional and antiwaiver provisions of the 1934 Act; the clear intent of Congress; the unbroken line of precedents of this Court and of the overwhelming majority of Circuit Courts; and overriding public policy concerns. Based upon the recent case law that has been developing in the lower courts on this issue, it is by no means overstating the case to assert that the Court's decision here will have a lasting effect now and in the future on the claims of hundreds of thousands of public customers who invest in the financial markets and thereby not only help to ensure the vitality of the capital markets but also generate substantial business and income for the brokerage industry.

This Court has often, in similar circumstances, sought to balance the mandate of the Federal Arbitration Act, 9 U.S.C. Section 1, *et seq.* ("FAA"), against its applicability in certain contexts of remedial, federal statutory legislation, and has in many cases, guided by legislative history and policy concerns,

found the FAA inapplicable.[1] In formulating exceptions to the scope of the FAA, and in other cases upholding its applicability, this Court has "focused not on sterile generalization, but rather on the substance of the transaction at issue, the nature of the relationship between the parties to the agreement, and the purpose of the regulatory scheme." *Southland Corp. v. Keating*, 465 U.S. 1, 20 (1984) (J. Stevens, concurring in part and dissenting in part); *Wilko v. Swan*, 346 U.S. 427, 438 (1953).

Section 2 of the FAA provides simply that a written arbitration agreement "shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. Section 2. In this case, the countervailing exception to the FAA is manifested in the 1934 Act itself, a statute whose underlying policy and remedial scheme must be reconciled with the acknowledged provisions of the FAA. The starting point for this inquiry, however, is not the unembellished language of the FAA, but the remedial provisions of the 1934 Act, the legislative history of the 1934 Act and judicial interpretation thereof. *See Randall v. Loftsgaarden*, ___ U.S. ___, 106 S.Ct. 3143, 3150 (1986).

The Second,[2] Third, Fifth, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits,[3] in other words, every other Circuit Court

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[1] *See McDonald v. City of West Branch, Michigan*, 466 U.S. 284 (1984) (upheld statutory cause of action under 42 U.S.C. Section 1983); *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728, 743-45 (1981) (upheld statutory cause of action under Fair Labor Standards Act); *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 56-58 (1974) (upheld statutory cause of action under Title VII, Civil Rights Act of 1964).

[2] *McMahon v. Shearson/American Express, Inc.*, 618 F.Supp. 384 (S.D.N.Y. 1985), *aff'd in part, rev'd in part*, 788 F.2d 94 (2d Cir. 1986), *cert. granted*, 107 S.Ct. 60 (No. 86-44, October 6, 1986).

[3] *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197 (3d Cir. 1986), *cert. pending*, No. 86-487; *Mayaja, Inc. v. Bodkin*, 803 F.2d 157

(Footnote continued)

but two[4] that have decided this issue, either before or after *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985), have adhered to a long-settled rule embodying Congressional intent, federal policy, and case law following this Court's decision in *Wilko*, that pre-dispute arbitration agreements are unenforceable with respect to claims under Section 10(b) of the 1934 Act.

The Court in *Wilko* held that a provision compelling arbitration prospectively is in effect an impermissible agreement by the public customer to waive the right to the protections of a judicial forum, and that subsequent claims arising under Section 12(2) of the Securities Act of 1933, 15 U.S.C. Section 77l(2) (the "1933 Act"), are not amenable to arbitration even under an agreement which would otherwise be enforceable under the FAA.[5] *Wilko* held that Congress, in enacting the antiwaiver

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(Footnote continued)
(5th Cir. 1986); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986), *cert. pending*, No. 86-321; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823 (10th Cir. 1978); *Wolfe v. E.F. Hutton & Co.*, 800 F.2d 1032 (11th Cir. 1986) (en banc). The Fourth and D.C. Circuits do not appear to have ruled *per se* on this question to date. *See also Tashea v. Bache, Halsey, Stuart, Shields, Inc.*, 802 F.2d 1337 (11th Cir. 1986) (per curiam); *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59 (5th Cir. 1986), *cert. pending*, No. 86-282; *Miller v. Drexel, Burnham, Lambert, Inc.*, 791 F.2d 850 (11th Cir. 1986) (per curiam); *DeLancie v. Birr, Wilson & Co.*, 648 F.2d 1255 (9th Cir. 1981); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976).

[4] *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, ____ F.2d ____, Slip Op. No. 86-1021 (1st Cir. November 26, 1986); reprinted in [Current] Fed.Sec.L.Rep. (CCH) ¶ 93,001, 94,914-94,916; *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393 (8th Cir. 1986), *cert. pending*, No. 86-578.

[5] It should be noted that agreements to arbitrate existing as distinguished from prospective disputes are enforceable. *See, e.g., Gardner v. Shearson*
(Footnote continued)

provision found in Section 14 of the 1933 Act, 15 U.S.C. Section 77(n), intended to prohibit a waiver of Section 22(a) thereof, 15 U.S.C. Section 77(v)(a), which grants concurrent state and federal court jurisdiction. *Wilko*, *supra*, 346 U.S. at 437.

Subsequently, in *Scherk v. Alberto Culver Co.*, 417 U.S. 506 (1974), where a negotiated agreement to arbitrate a commercial dispute arose out of a purely international transaction, the Court found "considerations and policies significantly different from those found in *Wilko*." *Id.* at 515. Although the Court noted a "colorable" argument for circumscribing the scope of *Wilko*, based upon certain perceived facial distinctions between the 1933 and 1934 Acts, it did not actually decide the issue of the arbitrability of 1934 Act claims.

In *Byrd*, although the Court again declined to resolve the applicability of *Wilko* to Section 10(b) claims, since the question was not before it, the Court acknowledged the viability of *Wilko* with respect to 1934 Act claims:

> "The Court [in *Scherk*] did not, however, hold that *Wilko* would not apply in the context of a § 10(b) or Rule 10b-5 claim, and *Wilko* has retained considerable vitality in the lower federal courts. Indeed numerous District Courts and Courts of Appeals have held that the *Wilko* analysis applies to claims arising under §10(b). . ., and that agreements to arbitrate such claims are therefore unenforceable."

Byrd, *supra*, 470 U.S. at 215-16 n.1. *Byrd* held only that pendent state law claims are arbitrable.

Respectfully, despite the reservations noted by Justice White in the concurring opinion in *Byrd*, the public policy rationale

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(Footnote continued)
Hammill & Co., 433 F.2d 367, 368 (5th Cir. 1970), *cert. denied*, 401 U.S. 978 (1971); *Moran v. Paine Webber, Jackson & Curtis*, 389 F.2d 242, 246 (3d Cir. 1968).

enunciated by the Second Circuit's decision in this case,[6] and the remedial purpose of protecting investors intended by Congress in enacting the securities laws and in amending them in 1975 are still valid, as recognized by the great *majority* of the Circuit Courts These considerations alone justify the continued extension of the *Wilko*[7] holding to deny compelled arbitration of 1934 Act claims. Any attempt to limit the application of *Wilko* to 1934 Act claims based upon artificial distinctions between the 1933 Act and the 1934 Act should therefore be rejected as wholly inconsistent with the plain statutory meaning and legislative intent underlying the securities laws. *See* n.12, *infra*.

That Congress intended, by enacting Section 10(b) of the 1934 Act, to protect the less sophisticated investing public from acts of fraud and manipulative practices by the brokerage industry is clear from the text of the statute:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

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[6] The *McMahon* decision manifestly does *not* reflect judicial distrust of arbitration by the Second Circuit, which has often stated that its decisions and policy reflect the contrary. *See, e.g., American Safety Equipment Corp. v. J.P. Maguire & Co.*, 391 F.2d 821, 827 (2d Cir. 1968), citing *South East Atl. Shipping Ltd. v. Garnac Grain Co.*, 356 F.2d 189, 192-93 (2d Cir. 1966); *Kulukundis Shipping Co., S.A. v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d. Cir. 1942).

[7] The assumption as to the nonarbitrability of Section 10(b) claims following *Wilko* and prior to Justice White's concurrence in *Byrd* was widespread. *See Conover, supra*, 794 F.2d at 521-22, citing, *e.g.*, A. Jacobs, *The Impact of Rule 10b-5*, § 237.02 (1980); A. Bromberg & L. Lowenfels, 2 *Securities Fraud & Commodities Fraud* § 5.16 (410) (1985). In *Scherk v. Alberto-Culver Co., supra*, 417 U.S. at 524-34, Justices Brennan, White and Marshall, joining in the dissent by Justice Douglas, opined that *Wilko* logically extended to 1934 Act claims. In *Byrd* the issue of whether 1934 Act claims are arbitrable was not properly before the Court, since the broker did not seek to compel arbitration of the federal securities claims. *Dean Witter Reynolds, Inc. v. Byrd, supra*, 470 U.S. at 215-16. *See also* L. Loss, *Fundamentals of Securities Regulation* 1193 (1983).

> of interstate commerce or of the mails, or of any facility of any national securities exchange. . . .
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate *in the public interest or for the protection of investors.*"

15 U.S.C. §78j(b)(emphasis added).

Consistent with this statutory scheme to protect the public, the SEC promulgated Rule 10b-5:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

17 C.F.R. §240.10b-5.

The legislative intent embodied in the 1934 Act, although containing some ambiguity as is often the case with congressional enactment, strongly indicates that Congress intended to create the right of action to enforce the duties arising under Section 10(b) of the 1934 Act, and concurrently, that the right to a federal judicial forum to enforce these duties is a provision that cannot be waived under Section 29(a) of the 1934 Act, 15 U.S.C. Section 78cc(a). Section 29(a) provides that any "stipulation" waiving "compliance" with *any* provision of the 1934 Act is void and unenforceable. Section 27, as set forth in 15 U.S.C. Section 78aa, provides, in pertinent part, as follows:

> "The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have *exclusive jurisdiction* of violations of this chapter or the rules and regulations thereunder, and of *all* suits in equity and actions at law brought to enforce *any liability or duty* created by this chapter or the rules and regulations thereunder." (emphasis added).

By providing for narrow, exclusive federal jurisdiction in the 1934 Act, to cover broadly *all* suits to enforce any *duty*, Congress must have intended that this special right to a judicial, federal court forum given under Section 27 is unwaivable and may not be so easily forfeited by virtue of Section 29(a).

Concededly, Congress' intent in this regard is implicit in the remedial scheme of the federal securities laws. When a plaintiff brings an action pursuant to Section 10(b), that party does so typically to enforce the duty, imposed upon securities brokers by that statute, not to use any manipulative or deceptive device in connection with the purchase or sale of securities in interstate commerce. Petitioners, relying on certain superficial "express/implied" differences they perceive in the securities laws, urge that Section 29(a) does not apply to the jurisdictional grant of Section 27 of the 1934 Act in the same way that Section 14 applies to Section 22 of the 1933 Act (Pet. Brief on the Merits 24). Forcing this result, however, is an obviously strained and

wholly inappropriate reading of the statutory language of the 1934 Act. To require that Section 10(b) claimants *must* arbitrate their grievances pursuant to a prospective, pre-dispute waiver, as argued by petitioners and their *Amici Curiae*, would effectively *eliminate* the grant of federal court jurisdiction under the 1934 Act in similar cases and undercut the remedial purpose of the securities laws. Such a result would not only be incongruous, and inconsistent with Congress' intent, but would constitute a forfeiture by public customers of their federal statutory rights at a time when the proportionate growth of the financial markets and concomitant rise in customer complaints against the brokerage industry call for greater, not fewer protections for the investing public. *See* discussion, *infra*.[8]

Prospective agreements to arbitrate claims arising under the securities laws are thus in the nature of prohibited stipulations waiving compliance with substantive provisions of both Acts. Under the parallel jurisdictional provision of Section 22 of the 1933 Act, such a stipulation infringes upon the right of a customer to *select* from state or federal judicial fora. Even more significantly, under the 1934 Act, the pre-dispute "agreement" to arbitrate not only infringes completely upon the vested right of the public customer to *exclusive* federal court jurisdiction, but effectively nullifies any opportunity, in such cases of prospective waiver, for 1934 Act claims to be heard in a court of law. As was noted recently by the Ninth Circuit Court of Appeals:

> "This distinction is an even more forceful indication of Congress' intent that federal courts oversee the

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[8] Respondents also raised the issues below that, as a contract of adhesion, the purported arbitration clause should not be enforced routinely without close scrutiny by the courts (R. at 21, 22), and that fraud and overreaching in the inducement of having a customer unknowingly waive statutory rights under the 1934 Act, by signing the standardized form of customer agreement, are justiciable claims (R. at 21, 22). *See Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 403-04 (1967). Ultimately, however, the standard of arbitrability rests not solely upon notions of unequal bargaining power, *e.g.*, but upon a proper analysis of the federal securities laws and underlying policy considerations which bar the enforceability of such agreements. *See McMahon*, *supra*, 788 F.2d at 97-98.

> interpretation and application of the 1934 Act . . . . the factors that led the *Wilko* Court to conclude that Congress intended to preclude enforcement of arbitration agreements under the 1933 Act can be no less applicable to claims under the 1934 Act."

Conover v. Dean Witter Reynolds, Inc., *supra* n.3, 794 F.2d at 527.[9]

The Second Circuit in this case held that the semantic distinctions between the 1934 Act and the 1933 Act do not withstand close scrutiny because they are, in practical terms, distinctions without substantive differences:

> "As our late colleague, Judge Friendly, noted in *Colonial Realty v. Bache & Co.*, 358 F.2d 178, 183 n.5 (2 Cir.), *cert. denied*, 385 U.S. 817 (1966), the non-waiver provision of §14 of the 1933 Act has an almost identical counterpart in §29(a) of the 1934 Act. In view of *Wilko* and the similarity of the non-waiver provisions of the 1933 and 1934 Acts, we consistently have held that §10(b) and Rule 10b-5 claims are not arbitrable. In *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103 (2 Cir. 1970), we observed that alleged violations of Rule 10b-5 were 'properly litigated in the courts where a complete record is kept of the proceedings and findings and conclusions are made.' We also pointed out the similarity between Section 14 of the 1933 Act and §29(a) of

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[9] *See also Barrowclough v. Kidder, Peabody & Co.*, 752 F.2d 923, 940 (3d Cir. 1985) ("There is an inherent incompatibility in referring to an arbitrator claims that fall within the exclusive jurisdiction of the federal courts and that arise as a part of a comprehensive scheme designed to assure protection to those individuals who fall within it. The Supreme Court has reached a similar conclusion with regard to analogous federal protective statutes."), citing *e.g.*, *Barrentine v. Arkansas-Best Freight System, Inc.*, *supra* n.1, 450 U.S. at 737.

> the 1934 Act. *Id.* In *Allegaert v. Perot*, 548 F.2d 432, 436-38 (2 Cir.), *cert. denied*, 432 U.S. 910 (1977), we reiterated the view that claims under §10(b) of the 1934 Act are not arbitrable, noting that the broad policy questions involved in securities law claims require a judicial forum for resolution of disputes. Again in *AFP Imaging Corp. v. Ross*, 780 F.2d 202, 205 (2 Cir. 1985), [*cert. denied*, June 30, 1986] we held that, in an action which alleged violations of §10(b) and Rule 10b-5, an arbitration clause in the contract was 'unenforceable under the law of this Circuit.' "

McMahon, *supra*, 788 F.2d at 96-97 (footnotes omitted).

Nothing in any of the recent decisions of this Court can be fairly interpreted as in conflict with the holding of the Second Circuit in *McMahon*. Indeed, even in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, ____ U.S. ____, 105 S. Ct. 3346 (1985), this Court clearly distinguished the international nature of the extensively and freely negotiated contract and antitrust dispute there, acknowledged an exception to arbitration in regard to claims in a domestic context and recognized that not all "controversies implicating statutory rights are suitable for arbitration." *Id.*, 105 S.Ct. at 3355.[10]

This Court has also determined that the provisions and remedies of the 1934 Act are not co-extensive with common law doctrines of fraud, [11] *Herman & MacLean v. Huddleston*, 459

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[10] *Mitsubishi* thus stopped short of overturning the "core" of the *American Safety* rationale that private plaintiffs, as quasi-attorneys-general, serve the public sector by enforcing their statutory rights and enforcing the regime of the antitrust laws, at least in the commercial domestic context, distinguishing international transactions. *Mitsubishi*, *supra*, 105 S.Ct. at 3358-3359.

[11] Section 10(b) plaintiffs must prove "scienter" by a preponderance-of-the-evidence standard while a fraud claimant at common law has a higher burden of proof by clear and convincing evidence. *See Herman & MacLean v. Huddleston*, *supra*, 459 U.S. at 388-389 (the Court found reference to common law standards "unavailing," since "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry." *Id.* at 389).

U.S. 375, 388-89 (1983), and that "a private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. *The existence of this implied remedy is simply beyond peradventure.*" *Id.* at 380 (citations omitted, emphasis added) citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In *Bateman Eichler v. Berner*, ____ U.S. ____, 105 S.Ct. 2622, 2628 (1985), the Court also rejected the argument that an implied remedy under Section 10(b) stood on any different footing from an express federal statutory remedy, citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).[12]

As this Court acknowledged in *Herman and MacLean v. Huddleston*, *supra*, 459 U.S. at 384-389, the rights afforded public customers under the 1933 and 1934 Acts in support of their remedial purpose are cumulative and "[t]he effectiveness of the broad proscription against fraud in Section 10(b) would be undermined if its scope were restricted by the existence of an express remedy under Section 11." *Id.*, 459 U.S. at 386 (citations omitted). Under this Court's holding in *Herman & MacLean v. Huddleston*, any interpretation of the securities laws that would have the effect of displacing an action under Section 10(b) was explicitly rejected. *Id.*, 459 U.S. at 387. Accordingly, consistent with the Court's previous analysis in *Herman*

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[12] Similarly, taking a position contrary to that adopted by petitioners, the SEC as *Amicus Curiae* commendably urges the Court to eschew artificial distinctions between the Acts and any perceived differences based upon implied and express causes of action:

> "[T]he Commission believes that it is important for the Court to avoid deciding this case on the basis of any supposed distinction between the two Acts or between express and implied causes of action. In particular, in the Commission's view, reliance on any distinction between express and implied causes of action has no place in the analysis, would be inconsistent with prior decisions of this Court, and *might impair the protections of the securities laws.*" SEC as *Amicus Curiae* 21 (emphasis added).

& MacLean, it would be improper to undermine the so-called "implied" but judicially and congressionally recognized right of action under the 1934 Act, by, *e.g.*, construing the anti-waiver provision of Section 29(a) to be inapplicable to the jurisdictional grant of Section 27, simply because there exists an "express" remedy under the 1933 Act.

Congress' intent that the substantive protections of the 1934 Act must necessarily include the provision against pre-dispute waiver of the right to bring claims in a federal judicial forum, with the full panoply of rights to judicial review and trial by jury, is deducible from both text and the legislative history, and is consistent with the remedial purpose of the 1934 Act. In its 1975 examination and revision of the securities laws, Congress in effect ratified *Wilko* and left undisturbed the unbroken line of precedent in this Court and the Circuits upholding the judicial forum for 1934 Act claims.[13] The Ninth Circuit Court of Appeals, in *Conover v. Dean Witter Reynolds, Inc.*, *supra*, 794 F.2d 520, found the Conference Report of the Congress compelling evidence that the legislative branch would permit pre-dispute arbitration agreements *only* between industry professionals, *i.e.*, brokers and exchanges:

> "That [legislative and judicial] history tells us, first, that the implied cause of action in federal court under section 10(b) and Rule 10b-5 has become well-established, and its nonwaivable character has become well accepted by the Securities and Exchange Commission, the courts of appeals and Congress itself.
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> * * *
>
> The legislative and judicial history tells us, second, that Congress could have eliminated the federal cause of action for section 10(b) in 1975, when it undertook comprehensive revision of the 1933 and 1934 Acts, had it chosen to do so. Congress' revision, however, left section 10(b) intact.

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[13] *See* Securities Act Amendments of 1975, Pub.L. 94-29, 89 Stat. 97 (1975); H.R. Rep. No. 94-229, 94th Cong., 1st Sess. (1975); S.Rep. 94-75, 94th Cong., 1st Sess. (1975).

> The history tells us, third, and most important, that in 1975, *Congress expressly recognized the nonarbitrable nature of disputes between brokers and customers*. In the conference report to the Securities Act Amendment of 1975, Congress emphasized that its amendment to section 28 of the Securities Exchange Act of 1934, which permitted arbitration agreements between brokers and exchanges, did not extend to arbitration agreements between brokers and customers:
>
> > 'It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in *Wilko v. Swan*, 346 U.S. 427... (1953), concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.'
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> H.R. Rep. No. 229, 94th Cong., 1st Sess. 111, *reprinted in* 1975 U.S. Code Cong. & Ad. News 321, 342."

Conover v. Dean Witter Reynolds, Inc., *supra*, 794 F.2d at 524 (citations omitted, emphasis added), citing *Hermann & McLean v. Huddleston*, *supra*; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 379 (1982) (finding, analogously, comprehensive amendments to Commodities Act evidence that Congress intended preservation of implied remedy under the Act).[14]

Many of the eight Circuit Courts of Appeals that have recently endorsed the principle of the nonarbitrability of 1934 Act claims have explicitly found the 1975 revisions apposite to this analysis.

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[14] While respondents are also cognizant of Justice Scalia's remarks, stated while on the Circuit Court bench in *Hirschey v. F.E.R.C.*, 777 F.2d 1, 7-8 (D.C. Cir. 1985), with regard to the minute particulars of congressional deliberations, petitioners have taken those observations out of context. Here, the scope of Congress' 1975 amendments, especially with respect to the 1934 Act, invite us to revisit the 1975 Conference Report.

Notably, the Eleventh Circuit Court of Appeals' en banc panel in *Wolfe v. E.F. Hutton & Co.*, *supra*, 800 F.2d 1032, while discerning no more or less than a simple endorsement of *Wilko* in the Conference Report, nonetheless found that Congress "declined to take further action," thereby acquiescing in the application of *Wilko* to Section 10(b) claims by the Courts. *Id.* at 1037-1038. *See* Section 28(b), 15 U.S.C. Section 78bb(b).

That Congress found it necessary at all to amend the 1934 Act with respect to Section 28(b) is significant to this inquiry. Certainly, if the antiwaiver provision of Section 29(a) were *arguendo* to have been deemed not to prohibit a pre-dispute waiver of the right under Section 27 to bring Section 10(b) claims in a judicial forum, then Congress would not have carved out the unequivocal but limited exception to the antiwaiver provision under Section 28(b), permitting arbitration agreements between brokers and exchanges. This is precisely the evidence of congressional intent required under the *Mitsubishi* test, in which the Court assumed

> "that if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention would be deducible from text or legislative history."

Mitsubishi, *supra*, 105 S.Ct. at 3355, citing *Wilko*.

The pre-dispute waiver at issue not only in this case, but in all the numerous cases now pending on the dockets of this Court and elsewhere, is unenforceable specifically because Congress has *not* excepted such pre-dispute arbitration agreements from the reach of Section 29(a). Congress clearly has never intended that relatively unsophisticated public customers could, unknowingly and in advance of a dispute, waive the protections of Section 29(a). When all factors are considered – the purpose, the legislative history and the focus and language of the statute itself – an exception to the FAA for respondents' claims under Section 10(b) of the 1934 Act must be upheld. This result is mandated by over thirty years of this Court's settled law and that

of the majority of the Circuits, the clear intent of Congress, established federal policy and the federal statutory rights afforded customers under the 1934 Act.

B. The Adequacy of The Arbitral Forum to Resolve Federal Securities Law Disputes Is Relevant to Whether Public Customers May Be Compelled to Prospectively Forfeit Their Federal Statutory Right to Judicial Scrutiny of Such Claims

Congress is today as concerned about protecting the public investor as it was when it enacted the securities laws over fifty years ago, and again when it enacted its comprehensive revisions in 1975. In its current session, the 100th Congress is embarking on a major reexamination of the effectiveness of the entire securities regulatory scheme in light of the damage recent insider trading cases have had on public investors' confidence in the fairness of the financial markets and the integrity of the brokerage industry. In the words of the Honorable John D. Dingell, Chairman of the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, Congress is currently scrutinizing the fundamental question of "whether self policing, in fact, works":

> "The U.S. capital markets have become the world's leaders precisely because of the strong public confidence in the basic integrity of those markets. *Events which shake that confidence — events which foster a public suspicion of unfairness — ultimately will destroy the effectiveness of those markets.*
>
> The hearing today is about just the kind of events which can destroy public trust and confidence. The questions we raise today about insider trading and stock manipulation will logically lead the Subcommittee in the coming year to look at corporate takeovers, leveraged buyouts, and the proper role of arbitrageurs.

In many ways, these are the same questions the House Commerce Committee was asking 50 years ago when it created the Securities and Exchange Commission and established the statutory framework for regulating the U.S. securities markets. At that time, the public was shocked by the revelations of stock manipulations, pools, insider trading and a host of other abuses. Now, we are facing what appears to be the biggest series of stock market abuses since the 1929 crash — abuses that led to the passage of the Securities Exchange Act of 1934.

* * *

At issue today is the effectiveness of the surveillance systems in the marketplace. Are the systems effective in deterring, detecting and prosecuting illegal trading? *What level of confidence can we have that individual investors are protected* against major institutional insider trading and stock manipulation?

The Levine and Boesky trading are good examples. The surveillance systems identified numerous Boesky and Levine trades, *but these referrals to the SEC did not lead to any enforcement action*. We must be careful not to be dazzled by the glitter of the technology of market surveillance and its effectiveness at this point. Before we can improve this system, *we have to face up to the clear limitations of the system*.

* * *

In fact, no one asked questions — not his employers — first Merrill Lynch and later Smith Barney — not the New York Stock Exchange, not the NASD, and not the SEC. Only when the broker began sharing his "tips" with a friend in Caracas did the scheme begin to unravel. His friend told a friend and together they began to piggyback as well. A third person, who

> was not cut in, apparently blew the whistle anonymously. Only with the anonymous tip did the Bank Leu/Dennis Levine scheme become clear and *has resulted in one of the greatest scandals since the creation of the SEC.*
>
> Over the next several months, the Subcommittee will examine these issues to determine whether the SEC needs additional authority to employ more radical investigative tools, and *whether self policing, in fact, works.*
>
> * * *
>
> Chairman Shad was finally convinced last Friday when at last he admitted that he did not have adequate enforcement personnel to police the securities markets."

Hearings Before the H.R. Subcommittee on Oversight and Investigations, *Insider Trading in the Securities Markets*, 99th Cong., 2d Sess. (Dec. 11, 1986) (opening statement of Hon. John D. Dingell, available from H.R. Committee on Energy & Commerce) (to be continued, 100th Cong., 1st Sess. 1987)).[15]

The gravity of this ongoing congressional inquiry into market abuses of monumental proportion and the inadequacies of self-regulation, begs the question of this Court whether, as a matter of congressional policy and intent, unsophisticated public customers should ever be compelled unknowingly, in advance of a dispute, to prospectively forfeit their statutory right to judicial scrutiny of their securities law claims, either under the 1933 Act or under the 1934 Act. Congress, by furnishing anti-waiver provisions to fortify the substantive arsenal of protections in both Acts, long-ago had the foresight to answer resoundingly in the negative. The public may *not* be compelled to forfeit such rights.

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[15] *See also* U.S. General Accounting Office, *Testimony: Insider Trading in the Securities Markets*, GAO/T-GGD-2 (Dec. 11, 1986) (statement of William J. Anderson Before H.R. Subcommittee on Oversight and Investigations) (available from H.R. Committee on Energy & Commerce).

Also at issue, in view of Congress' concurrent interest, is the adequacy of procedures to resolve customer disputes. There is ample evidence,[16] besides that represented by Congress' inquiry, to support this Court's finding as articulated in *Byrd* that the *Wilko* doctrine, together with its underlying rationale, is indeed still both good and necessary law in order to promote the confidence and protection of the public in the financial markets. *Byrd*, *supra*, 470 U.S. at 215-16 n.1. As one commentator has noted:

> "Arbitration procedures have not changed sufficiently since *Wilko* was decided to eliminate the Court's fundamental objections to allowing adversaries to arbitrate Securities Act claims. Arbitration is not as effective as adjudication in federal court as a means of protecting investors' rights because the purposes underlying arbitration fundamentally conflict with the right to a federal forum granted under the Securities Act and the Exchange Act."

Note, *Arbitrability of Claims Arising Under the Securities Exchange Act of 1934*, 1986 Duke L.J. 548, 552 and discussion with citations at 552-555. *See also* SEC Securities Exchange Act Release No. 20397 [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,452 at 86,357 and n.6. (Nov. 18, 1983), discussed *infra*.

Contentions regarding the adequacy of the arbitral forum, while not dispositive of the question of the arbitrability *vel non* of statutory claims, have been raised by petitioners and *Amici* in support of petitioners. The issue is relevant here and must be addressed (*see* SEC as *Amicus Curiae* 7, 18-19), if the substantive remedies of the securities laws, enacted to protect the public customer, are to be left intact and accorded the importance that continues to be attached to them by Congress and the Courts,

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[16] The evidence is to be found in the relevant decisions of the eight Circuit Courts of Appeals, *supra* n.3.

and not least by the SEC, which today affirms that the Section 10(b) remedy is a significant adjunct to Commission oversight and action. SEC as *Amicus Curiae* 26. *See also J.I. Case Co. v. Borak*, *supra*, 377 U.S. at 432.[17]

Arbitration, while *relatively* quick, inexpensive and informal when compared to a court proceeding, must be balanced against the loss of constitutional guarantees of due process, trial by jury, findings of fact and conclusions of law, federal pleading, discovery and evidentiary rules, and compulsory, orderly discovery; the risk that the law will be improperly applied to the facts at issue; the possible risk of collateral estoppel or inconsistent verdicts; and the unlikelihood, if not unavailability, under various rules of the industry's self-regulatory organizations ("SROs"),[18] of the right to appeal. *See, e.g., Sobel v. Hertz, Warner & Co.*, 469 F.2d 1211 (2d Cir. 1972), *rev'g* 338 F.Supp. 287 (S.D.N.Y. 1971). The limited right to appeal is diminished still further because arbitrators are not required to state the basis for their decisions, thus eliminating any rational ground for testing the legal sufficiency or remedial adequacy of awards.

Remarkably, petitioner Shearson has invoked these same characteristics, supporting its own claims of irreparable harm and inherent unfairness of SRO arbitration proceedings, in memoranda its counsel has submitted in *Shearson Lehman*

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[17] *See generally Alexander v. Gardner-Denver Co.*, *supra*, 415 U.S. at 57, citing *U.S. Bulk Carriers v. Arguelles*, 400 U.S. 351 (1971) ("the choice of forums inevitably affects the scope of the substantive right to be vindicated."); *Bernhardt v. Polygraphic Co. of America, Inc.*, 350 U.S. 198 (1956) ("[A]rbitration, whatever its merits or shortcomings, substantially affects the cause of action created by the State. The nature of the tribunal where suits are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result.") *Id.* at 203.

[18] *See generally* Uniform Code of Arbitration, N.A.S.D. Manual (CCH) ¶¶ 3701-3743 (1986); Arbitration Rules of the American Stock Exchange, 2 Am. Stock Ex. Guide (CCH) ¶¶ 9540-9551J (1984); and Arbitration Rules of the New York Stock Exchange, Inc., 2 N.Y.S.E. Guide (CCH) ¶¶ 2600-2634 (1985).

Brothers, Inc. v. Lyle Lamers, No. B-86-507 (D.Conn. pending Oct., 1986) (TFGD), an injunctive action brought by Shearson in which it is, paradoxically, *opposing* the jurisdiction of the New York Stock Exchange to consider claims asserted by a public customer. The self-serving animus of the industry in promoting arbitration when it serves its purpose, but not consistently, is thus best illustrated by such methods used by brokers themselves to avoid arbitration and the jurisdiction of SROs. As noted by Donald Malawsky, senior vice present of enforcement at the New York Stock Exchange, brokers may thus thwart even the disciplinary efforts of the SROs: "the firm will settle up with a customer [before reaching the arbitration stage], and then he [sic] stops cooperating with us and won't be a witness," quoted in NEWSWEEK, December 22, 1986, at 43.

Furthermore, since judicial review of both SRO and American Arbitration Association ("AAA") decisions is strictly limited,[19] a repeal or even abridgement of the scope of *Wilko*[20] would effectively insulate the entire brokerage industry from statutory liability and judicial scrutiny of claims brought by public customers who have prospectively waived their rights arising

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[19] This is so in part because arbitration institutionalizes the practice of rendering decisions without giving reasons. According to the President of the AAA, Robert Coulson: "Written opinions can be dangerous because they identify targets for the losing party to attack." R. Coulson, *Business Arbitration — What You Need to Know* 26 (1980), cited in Note, *supra*, 1986 Duke L.J. at 553 n.37. Under the FAA, 9 U.S.C. §10, and the various uniform rules at the stock exchanges and elsewhere governing arbitration, the only limited grounds to challenge an award are: undisclosed relationship affecting impartiality of panel; corruption of arbitrator; unfair conduct of hearing; and relief not authorized under contract. Erroneous findings of fact or misinterpretations of law are not usually grounds for a court to reverse an award absent irrationality or manifest disregard of law. And arbitrators are not even bound to follow the precedent of prior awards. Note, *supra*, 1986 Duke L.J. at 553-54, n.38 and citations therein. *See also* J. Malcolm & E. Segall, *The Arbitrability of Claims Arising Under §10(b) of the Securities Exchange Act: Should Wilko Be Extended?*, 51 Albany L. Rev. 1 (forthcoming Winter 1987) (*accord* with premise of *McMahon*, *infra*).

[20] *See* AAA as *Amicus Curiae* 21; Brief for SEC as *Amicus Curiae*.

under both the 1933 and 1934 Acts. *Compare Axelrod & Co. v. Kordich, Victor & Neufeld*, 451 F.2d 838, 843 (2d Cir. 1971) ("Without such a [non-waiver] provision, financial houses might escape statutory liability by taking advantage of the inferior bargaining position of customers.").

The overriding policy consideration involved in this case is the protection of the public investor against manipulation and deception in the financial markets, the same consideration which culminated in Congress' enactment of the securities laws in the first place. As has been discussed above, there are many significant rights, both substantive and procedural, that are literally unavailable in the arbitration process. Consequently, when a customer is not given the opportunity to make an informed choice, and prospectively forfeits the judicial forum, the result is not only to give unfair advantage to the brokerage industry, but to encroach upon the very substantive rights provided in the 1934 Act, among them full disclosure, fair dealing and judicial scrutiny.

The SEC as *Amicus Curiae* 20-21, while suggesting that a "separate analysis would be necessary to determine whether the arbitration procedures [at other than SROs] are adequate to protect statutory rights," offers no proof for its perplexing assertion that as a result of its oversight authority, under Section 19 of the 1934 Act, 15 U.S.C. Section 78s, *et seq.*, *a fortiorari*, the "uniform" SRO arbitration procedures must be both adequate and fair. SEC as *Amicus Curiae*, *e.g.*, 20. This conclusion is offered without any explanation as to the manner in which SRO arbitration adequately protects public customers' statutory rights (including rights against pre-dispute waiver of the protections offered under the federal securities laws).[21] Neither the Securities

[21] Apparently, the SEC's position, which seems wholly inconsistent with SEC policy and releases, was reached only after strenuous debate among Commission staff. The Nat'l L.J., Dec. 15, 1986, at 15, cols. 1-4 ("The decision to file the brief, which reverses a position the SEC took . . . was controversial within the commission, according to sources familiar with the debate.").

Industry Association ("SIA")[22] nor the AAA, as *Amici Curiae*, adequately explains how the uniformity of these rules, without more, promotes fairness or the adequate enforcement of the securities laws. Ultimately, such issues of fairness, disclosure and protection of the rights of the public in the financial markets must be resolved in favor of the public securities consumer.[23]

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[22] The statistics cited, *e.g.*, by the SIA as *Amicus Curiae* 10-11, are misleading. There is no indication as to how many of the claims filed with the SROs arose under Section 10(b) as opposed to another statute, such as Sections 11, 12(2) or 17(a) of the 1933 Act, or how many were never subject to an arbitration agreement to begin with. *See also* AAA as *Amicus Curiae* 16 n.21. Moreover, in light of the evidence assembled by Congress, the increase in the number of arbitration filings is less a function of the acceptance of arbitration than a reflection of the exponential increase in customer complaints. In statistics compiled by Congress, in conjunction with the SEC, "the incidence of securities law violations is proportional to the size and activity of the securities market. From [1977 through 1983], the securities industry grew quite rapidly .... the number of shares traded on the New York Stock Exchange increased from 5.2 billion ... to 21.6 billion ... a net increase of over 300 percent .... The growth in the industry was accompanied by a corresponding increase in the indications of potential securities law violations. Specifically, the number of public complaints and inquiries to SEC alleging security law violations increased from 8,500 to almost 29,000 between fiscal years 1977 and 1983." U.S. General Accounting Office, Report to the Chairman, Subcommittee on Oversight and Investigation, Committee on Energy and Commerce, House of Representatives, *Statistics on SEC's Enforcement Program*, GAO/GGD-85-28 at 3 (Mar. 25, 1985).

[23] As an American Bar Association subcommittee has found in its preliminary (to date unpublished) inquiry, arbitration at the SROs is an inadequate procedure to enforce statutory duties under the securities laws. Practising Law Institute Forum, *Solving Securities Disputes* (Address by Sheldon H. Elsen, Esq., ABA Subcommittee Chairman, October 1, 1986). *See also* Victor, *Circuits Split on Securities Fraud Arbitration*, The Nat'l L.J., July 28, 1986, at 8, cols. 1-3. ("Most of the bar knows that it's a stacked deck in favor of the [investment] houses," quoting Sheldon H. Elsen, Esq.). Various consumer statutes have been enacted which in effect codify similar concerns about arbitral impartiality. *See, e.g.*, Consumer Product (Magnuson-Moss) Warranty Act, 15 U.S.C. §§ 2302(a)(8), 2310(d); N.Y. Gen. Bus. L. § 399-c (McKinney 1986-87) (prohibition of mandatory arbitration clauses).

C. Congress' Continuing Inquiry Into the Effectiveness of the Regulatory Scheme Governing the Securities Markets Manifests Its Overriding Solicitude for Protecting and Strengthening the Full Panoply of Rights of Public Customers Under the Securities Laws

It is respectfully submitted that the institution of SEC oversight authority over the SROs since 1975 is not an adequate reason for the Court to either "decide this case without broader consideration of the principles affecting the arbitrability of statutory claims generally" as is urged by the SEC as *Amicus Curiae* 14, or without a review of the fact that oversight alone has been found by Congress to be inadequate to protect the rights of public customers in its day to day dealings with the industry. While respondents do not wish to suggest, and have no independent means of determining, that the Commission does not provide excellent regulatory and rule-making guidance to the SROs, nevertheless, it is incontrovertible that as a practical matter it is left to the SROs and not the SEC to actually conduct the individual arbitration proceedings involving public customer-broker disputes.

Yet the failure of SRO procedures generally, in spite of SEC oversight, has been documented in detail by the U.S. General Accounting Office ("GAO"), the investigative arm of Congress, in its Report to the Chairman, Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, House of Representatives, *Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation*, GAO/GGD-86-83 (Sept. 30, 1986) (hereinafter, "GAO Report on SEC Oversight"). While the GAO Report on SEC Oversight does not specifically comment upon arbitration procedures, it does underscore some significant failings of SRO handling of customer-broker disputes. For example, some SROs have experienced substantial backlogs in their handling of customer complaints and terminations of brokers for cause:

> "Between 1982 and 1984, the number of complaints received increased by 97 percent, the number resolved

> increased by 93 percent, and the number pending increased by 152 percent (to 1,565 actual cases). Moreover, the number of complaints that were pending for over 3 months grew by 218 percent (to 940 actual cases)."

GAO Report on SEC Oversight at 63. *See also* n.22, *supra*.

Another finding, germane to the activity public customers have with the SROs, is that "Commission [SEC] regional offices considered the SROs to be less able than the Commission to identify and take effective action on sales practice cases." GAO Report on SEC Oversight at 62. In practical terms, this means, for example, that SRO examinations are often not thorough; the review of customer accounts is based on a random sample rather than on a more time-consuming review of the most active accounts or the accounts that could be traded without the customer's knowledge; SRO examiners would thus not necessarily be looking at the accounts of public customers in sales practice matters, such as churning, most likely to be subject to abuse; and not least, the SROs lack sufficient personnel to handle sales practice matters. *Id.* at 62.

> "As a result of these perceptions, the [Commission's] regional offices appeared less likely to refer complicated sales practice violations to the SROs. Out of 117 closed referrals (referrals on which final SRO action had been taken) made to the SROs between January, 1983 and June, 1984, 46 had sales practice violations as the principal type of violation. Only 2 of the 46 cases concerned churning, considered a complicated sales practice violation; the remaining 44 sales practice matters that were referred and closed primarily involved the suitability of a security recommended for investment, considered a more straightforward violation to pursue."

Id. at 62. (citation omitted).

The virtual abandonment of the public customer's interests when they conflict with SRO "self-discipline" is apparently commonplace:

> "the prosecution of sales practice abuses highlighted a limitation of the self-regulatory system. . . . Even where SRO staff had aggressively investigated violations, disciplinary panels composed of members often appeared reluctant to sanction their peers."

GAO Report on SEC Oversight at 46-47. This conflict of interest, which spills over into SRO arbitrations where at least one panel member is typically an industry representative, arises, naturally enough, from the fact that the SROs are private concerns owned largely by the brokerage industry's member firms, among others. The resulting difficulty in enforcing, *e.g.*, the anti-churning aspect of the securities laws, apparently a burgeoning area of sales practice violations, is not lost on knowledgable observers of the industry and the SROs: "There's no doubt about the conflict facing the exchanges when they are supposed to discipline member firms. On the whole, the exchanges' records have been spotty." MONEY, Nov. 1985, at 226-236, 234 (quoting Norman Poser, Professor, Brooklyn Law School, former executive vice president of the American Stock Exchange ("AMEX"); Robert Shabazian, assistant vice president of AMEX ["Based upon our compliance department's investigations over the past three years, there has been an increase in churning." *Id.*]; Donald Malawsky, senior vice president of enforcement at the N.Y. Stock Exchange ["Unauthorized trading in customers' accounts is way up from five years ago." *Id.*]).

It is respectfully submitted that despite SEC oversight authority over the SROs, procedures generally at the SROs are simply inadequate to ensure that customers will get a fair review of their claims in arbitration. Concededly the SEC has selectively allocated its limited resources and manpower in this area. The executive director of the SEC, George G. Kundahl, in responding by letter dated July 11, 1986 to another GAO Report, *SEC Enforcement Program: Information on Productivity;*

Statements and Cases Closed Without Action, GAO/GGD-86-106BR (Aug. 26, 1986), stated the following concerning the manner in which the SEC narrowly executes its oversight authority:

> "In selecting matters for investigation, Commission managers *consider not only specific characteristics, such as the potential dollar value and number of investors involved*, but also intangible factors such as the deterrent value of a particular case."

Id. at Appendix IV, 21 (emphasis added).

This Court was similarly advised by the SEC as *Amicus Curiae* in *Bateman Eichler* that the SEC

> " 'does not have the resources to police the industry sufficiently to ensure that false tipping does not occur or is consistently discovered,' and that '[w]ithout the tippees' assistance, the Commission could not effectively prosecute false tipping — a difficult practice to detect.' "

Bateman Eichler v. Berner, *supra*, 105 S.Ct. at 2631, citing Brief for SEC as *Amicus Curiae* 25; H.R. Rep. No. 98-355, at 6 (1983) ("In recent years, the securities markets have grown dramatically in size and complexity, while Commission enforcement resources have declined.").[24]

This evidence warrants further inquiry into the bare assertion by the SEC as *Amicus Curiae* that, although the Commission will not vouch for procedures elsewhere, public investors as a whole are adequately protected in arbitral proceedings at the SROs. SEC as *Amicus Curiae* 13 *et seq*. If, by its own

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[24] *See* GAO Report, GAO/GGD-86-106BR, *supra*, App. IV at 21; *See also* H.R. Rep. 99-155, 99th Cong., 1st Sess. (1985) ("the SEC has limited resources and, understandably, must target its efforts on the largest, national threat to investor protection and market integrity.") *Id.* at 26 (Letter from President, North American Securities Administrators Assoc., Inc. to Hon. Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance).

admission to the accounting arm of the Congress, the SEC selectively "weeds out" those cases it deems too small or otherwise insignificant for its oversight,[25] a fair conclusion is that the thousands of public customers whose claims fall within this category are simply *not* protected by SEC oversight. The incontrovertible fact, unrebutted by petitioners in their brief on the merits and by their *Amici Curiae*, is that the SEC's oversight and regulatory authority over the SRO's, *per se*, is in actual practice, and considering the SEC's current budgetary constraints,[26] neither a guarantee of the fairness and adequacy of SRO arbitration procedures nor of procedures in other arbitral forums, such as the AAA, where the SEC exercises no authority.

Recently publicized revelations[27] about illegal insider trading and concomitant market manipulation, of which the Court is respectfully asked to take judicial notice, has heightened public awareness that all is not right with the financial marketplaces that deal with the public. Against this context, petitioners, and the SEC and SIA as *Amici Curiae*, argue generally, without any supporting evidence, that arbitral procedures for securities law claims are sound, either because of their outward indicia of uniformity and orderliness, or because of the Commission's general oversight authority, or a combination of the two. This

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[25] *See also* MONEY, *supra*, Nov. 1985, at 234: "But the SEC, by the admission of the New York office's [former] regional administrator, Ira Sorkin, has taken a less active role in prosecuting cases in the past two or three years. Instead, it refers most of them to the stock exchanges and broker-dealer associations because it doesn't have the staff to scrutinize millions of daily trades."

[26] H.R. Rep. 99-155, 99th Cong., 1st Sess., *supra* n.24, at 3 ("These and other events [of broker fraud and financial collapse of securities dealers, e.g.] have placed increased demands on the ability of the Commission, at its current funding and staffing levels, to protect investors and maintain the integrity of the nation's securities markets.").

[27] *See, e.g.*, N.Y. Times, Jan. 2, 1987, at B6, cols. 3-6; *id.*, Dec. 12, 1986, at A1, col. 1-D4, cols. 3-4; *SEC v. Boesky*, [Current] Fed.Sec.L.Rep. (CCH) ¶ 92,991, at 94,856 (S.D.N.Y. Nov. 14, 1986).

reasoning is flawed. It ignores the policy rationale advanced by the majority of the Circuit Courts of Appeals and fails to weigh meaningfully any considerations of congressional intent underlying the securities laws. As a transparent effort by the brokerage industry and its champions to shift the Court's focus away from the substance of policy to the form of procedure, petitioners' argument is ultimately unpersuasive.

D. The Fundamental Goals of the 1934 Act Are Impermissibly Undermined By Prospective Waivers of Its Statutorily Provided Rights

Just last term, Justice O'Connor, who delivered the opinion of the Court in *Randall v. Loftsgaarden*, revisited the legislative rationale underlying the protections with which public customers are vested under the 1934 Act:

> ". . . Congress' aim in enacting the 1934 Act was not confined solely to compensating defrauded investors. Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions. *Affiliated Ute Citizens*, *supra*, at 151, 92 S.Ct. at 1471; *see also Hermann & MacLean*, 459 U.S., at 386-387, 103 S.Ct. at 1144-1145."

Randall v. Loftsgaarden, *supra*, ____ U.S. ____, 106 S.Ct. at 3154.

Consistent with these fundamental goals, the clear concern of the SEC, in addressing the pervasiveness of overreaching and manipulative practices in the securities industry in its dealings with public customers, has been the deterrence of fraud and ensuring the fullest possible disclosure. Thus, in 1979, the SEC acknowledged the self-same problem of non-disclosure and manipulation occurring at the time a customer opens an account that is at issue in the *McMahon* case:

> "It is the Commission's view that it is misleading to customers to require execution of any customer agreement which does not provide adequate disclosure

> about the meaning and effect of its terms, particularly any provision which might lead a customer to believe that he or she has waived prospectively rights under the federal securities laws . . . . Customers should be made aware prior to signing an agreement containing an arbitration clause that such a prior agreement does not bar a cause of action arising under the federal securities laws."

SEC Securities Exchange Act Release No. 15984, [1979 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,122, at 81,977-81,978 (July 2, 1979). *See also* SEC Securities Exchange Act Release No. 19813, [1982-83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶83,356, at 85,967 n.6 (May 26, 1983).

Just three short years ago, the SEC enacted regulation 15c2-2, 17 C.F.R. Section 240.15c2-2, to correct the continuing industry-wide practice among brokers of failing to disclose to their public customers that, by signing a boiler-plate form of customer agreement containing an arbitration clause, the customer had not necessarily prospectively waived vested rights to a judicial forum under the federal securities laws. SEC Securities Exchange Act Release No. 20397, *supra*, [1983-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶83,452. Although the SEC, as *Amicus Curiae* 18, has not explicitly asserted in this case a repeal of Rule 15c2-2, its argument in support of a repeal of *Wilko* (SEC as *Amicus Curiae* 20) effectively undermines its earlier effort in support of full disclosure to public customers of their rights and against overreaching by brokers.

The obvious inconsistencies of this position render its premise, that full disclosure is now somehow obviated by oversight, untenable, especially since the SEC as *Amicus* readily concedes that "[t]his Court noted in *Mitsubishi Motors Corp.*, slip op. 12, that fraud and overreaching remain grounds for revoking an arbitration agreement." SEC as *Amicus Curiae* 19. But in *Mitsubishi*, the Court also stated that "the first task of a court asked to compel arbitration of a dispute is to determine whether the parties agreed to arbitrate that dispute," *Mitsubishi*, *supra*,

105 S.Ct. at 3354, and that "[o]f course, courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.' " *Id.* Clearly, petitioners' efforts to abridge or abrogate altogether public customers' statutorily provided rights to full disclosure, by seeking to enforce all prospective waivers of such rights, represent an unwarranted, intolerable departure from congressional intent and prior SEC releases, as interpreted by almost all the Circuit Courts of Appeals, and would also conflict with the plain meaning of *Mitsubishi*.

Nor may petitioners reasonably claim that the SEC's position is strictly a result of its previous understanding of the application by the courts of the *Wilko* rule to Section 10(b) claims. As early as 1951, in a release that pre-dates *Wilko*, the SEC censured the brokerage industry for the use of analogous clauses which, lacking adequate disclosure, were deemed patently inconsistent with "just and equitable principles of trade and may raise serious questions of compliance with the anti-fraud provisions of the federal securities laws," including the 1934 Act.[28]

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[28] SEC Securities Exchange Act Release No. 58 (Apr. 10, 1951), quoted in SEC Securities Exchange Act Release No. 19813, [1982-83 Transfer Binder] Fed.Sec.L.Rep (CCH) ¶83,356, 85,967 n.6:

> "This reasoning by the Commission was not novel. In 1951, the Commission released an opinion by its General Counsel concerning the use of 'hedge clauses' by brokers, dealers, investment advisers and others who sought thereby to avoid liability for a representation which they knew, or in the exercise of reasonable care could have discovered, to be false and misleading. The courts had repeatedly struck down such clauses. *See* Investment Advisers Act Release No. 58 (April 10, 1951). The position expressed in Release No. 58 was as follows:
>
> > 'All the statutes administered by the Commission provide that any condition, stipulation or provision which binds any person to waive compliance with their requirements shall
>
> *(Footnote continued)*

The SEC's obvious and sustained concern over three decades has been that public customers, such as respondents, would be induced to either submit to arbitration, uninformed of their vested rights to a judicial forum under the securities laws, or possibly not pursue their claims at all. SEC Exchange Act Release No. 15984, *supra*, [1979 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,122 at 81,978. Yet SEC endorsement of disclosure is linked to the limitations of oversight. In response to an inquiry by Chairman Dingell of the House Subcommittee on Oversight and Investigations, the SEC recently *conceded* its total *lack* of oversight authority over actual SRO arbitration proceedings: "The Commission has *no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code* [Uniform Code of Arbitration] *or accurate interpretations of underlying federal securities law* or other claims by the arbitrators."[29] Since SEC oversight authority does not police the actual day to day broker-customer relationship, the intent if not the letter of SEC regulations now in place, which promote full disclosure, should not be unnecessarily curtailed by the judiciary at a time when customers need more, not fewer, protections.

(Footnote continued)

> be void. . . .The question arises, therefore, whether the result, if not the purpose, of such a legend is to create in the mind of the investor a belief that he has given up legal rights and is foreclosed from a remedy which he might otherwise have. . .under the SEC statutes. . . .the antifraud provisions of the SEC statutes are violated by the employment of any. . .provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have,. . . .[under] Section 10(b) of the Securities Exchange Act of 1934 and Rule [10b-5] thereunder, Section 15(c)(1) of that Act and Rule [15c1-2] thereunder. . . .' "

Id. at ¶83,356, 85,967 n.6.

[29] SEC Report of the Division of Market Regulation In Response to An Inquiry By the Honorable John D. Dingell, Chairman of the Committee on Energy and Commerce Concerning a Complaint by Joan Hunt Smith (August 28, 1986) (available from H.R. Committee on Energy & Commerce) (emphasis added).

Depriving public customers of a federal judicial forum as provided in the 1934 Act by Congress would only serve to undermine the public's confidence further. Respondents, who symbolically represent the cause of countless public customers in like circumstances, are in reality consumers in the securities marketplace, whose rights and protections only Congress has the authority to amend. The SEC as *Amicus* has itself affirmed the importance of the Section 10(b) remedy as a supplement to Commission action, and as an important weapon in the "arsenal of securities law protections." SEC as *Amicus Curiae* 26. In light of congressional intent and policy considerations underlying the regulatory scheme of the securities laws, respondents respectfully urge the Court to exercise its judgment and to find that, at least in this instance, the FAA must be accomodated in the context of the remedial federal securities laws, and that public customers shall not be compelled, despite a predispute waiver of the judicial forum, to arbitrate claims that arise under the 1934 Act.

II. Compelling Legislative History and Public Policies Preclude Arbitration of Civil RICO Claims

A. Congress Intended to Create an Exception to the FAA for Civil RICO Claims

That Congress intended to except civil RICO claims from the purview of the FAA is deducible from the statutory text. The grant by Congress to civil litigants of a private right of action and federal court jurisdiction of RICO claims is expressly provided in 18 U.S.C. Section 1964(c):

> "Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee."

By incorporating into the RICO statute the parallel jurisdictional and treble damage provisions of the analogous federal

antitrust laws, embodied principally in Section 4 of the Clayton Act, 15 U.S.C. Section 15, Congress was creating in effect a private attorney general provision, based upon the antitrust model, "in part designed to fill prosecutorial gaps." *Sedima, S.P.R.L. v. Imrex Co.*, ___ U.S. ___, 105 S.Ct. 3275, 3284 (1985).

Following the enactment of the RICO statute, numerous Circuit Courts, finding the antitrust analogy persuasive, have held arbitration of RICO claims to be unsuitable because of public policy concerns and statutory rights that cannot be adequately vindicated by the arbitration process.[30] *See, e.g., Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., supra* n.4, ___ F.2d ___, No. 86-1021 (1st Cir., Nov. 26, 1986), reprinted in [Current] Fed.Sec.L.Rep. (CCH) ¶93,001, 94,914-94,916 (all civil RICO claims not arbitrable); *Tashea v. Bache, Halsey, Stuart, Shields, Inc., supra* n.3, 802 F.2d 1337, 1339 (11th Cir. 1986) (per curiam) (civil RICO claims, predicated on violations of the securities laws, not arbitrable); *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra* n.3, 797 F.2d 1197, 1202 (3d Cir. 1986) (civil RICO claims, when predicated on nonarbitrable offenses, not arbitrable); *McMahon, supra* n.2, 788 F.2d at 97-98. *See also S.A. Mineracao da Trinidad-Samitri v. Utah International, Inc.*, 576 F.Supp. 566 (S.D.N.Y. 1983), *ordered certified for interlocutory appeal*, 579 F.Supp. 1049 (S.D.N.Y.), *appealed on other grounds and aff'd*, 745 F.2d 190 (2d Cir. 1984). *Contra Mayaja v. Bodkin, supra* n.3, 803 F.2d 157, 162 (5th Cir. 1986).

The Second Circuit in *McMahon* found the private attorney general model compelling and compared favorably the policy concerns shared in enforcement of both the RICO statute and the antitrust laws:

> "In other contexts, we have recognized the inappropriateness of the United States Arbitration Act when strong public policy considerations are involved.

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[30] *See also* Pet. App. F, subparagraph B, A46-A48.

> In *American Safety Equipment v. J.P. Maguire* 391 F.2d 821 (2 Cir. 1968), we stated that '[a] claim under the antitrust laws is not merely a private matter. The Sherman Act is designed to promote the national interest in a competitive economy; thus, the plaintiff asserting his rights under the Act has been likened to a private attorney-general who protects the public's interest.' 391 F.2d at 826. We hold that there are comparable concerns inherent in the enforcement of RICO claims.
>
> The Supreme Court has recognized that arbitration is appropriate in *international* antitrust disputes because of concerns for international comity, respect for the capacities of foreign and transnational tribunals, and the need for predictability in the international commercial system. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S.Ct. 3346 (1985). The reasoning of our decision in *American Safety*, however was not disputed in *Mitsubishi*, 'as applied to agreements to arbitrate arising from domestic transactions.' 105 S.Ct. at 3355. Enforcement of the RICO statute is particularly appropriate in a judicial forum because of strong policy concerns, the need for development of the record, and judicial clarification and resulting consistency in resolving disputes under this relatively new statute."

McMahon, supra, 788 F.2d at 98.

This Court's decision in the *Mitsubishi* case, which arose in the context of an international dispute, was not meant to nor does it emasculate the premise of the Second Circuit holding making unenforceable prospective agreements to arbitrate RICO claims in the context of domestic transactions. When this Court analyzed the private attorney general model and the legislative history of the Sherman and Clayton Acts in *Mitsubishi*, the "core" of that model, the "fundamental importance to American democratic capitalism of the regime of the antitrust laws," was

left intact. *Mitsubishi*, *supra*, 105 S.Ct. at 3358. Not only did the Court find that the private cause of action was central to the enforcement of the statutory scheme, but also that the "treble-damages provision. . . pos[es] a crucial deterrent to potential violators." *Id. Mitsubishi*, however, enforced an agreement to arbitrate an *international* antitrust dispute,[31] but did so "*even assuming a contrary result would be forthcoming in the domestic context.*" *Id.* at 3355 (emphasis added).

Similarly, in *Sedima* the Court found in the legislative history of RICO's private treble damages remedy clear legislative intent to apply the antitrust model adapted by RICO as a means to combat organized criminality, whether touching legitimate or illegitimate businesses. *Sedima*, *supra*, 105 S.Ct. at 3280-3281. Even more significantly, bearing on the question *sub judice* whether RICO claims are best adjudicated in a court of law, *Sedima* held that

> "... to the extent an action under §1964(c) might be considered quasi-criminal, requiring protections normally applicable only to criminal proceedings,. . . *the solution is to provide those protections*, not to ensure that they were previously afforded by requiring previous convictions."

Sedima, *supra*, 105 S.Ct. at 3283-3284 (citations omitted, emphasis added).

The Court's implicit acknowledgment in *Sedima* of the quasi-criminal nature of RICO's private civil remedy, and its reservations in the context of domestic transactions in *Mitsubishi*, were held recently by the First Circuit Court of Appeals to be compelling evidence that only courts may adjudicate RICO claims:

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[31] *Cf. Mitsubishi*, *supra*, 105 S.Ct. at 3365 ("The Court has repeatedly held that a decision by Congress to create a special statutory remedy renders a private agreement to arbitrate a federal statutory claim unenforceable.") (Stevens, J. dissenting).

> "*Mitsubishi*, in our estimation, allows for judicial inferences of an *implied Congressional intent to bar arbitration*, especially in light of express rights of action and in the context of a proceeding that involves adjudication of conduct subject to criminal as well as civil sanctions. *See* 18 U.S.C. §§ 1961(1), 1962, 1964(c). Second, we note that it is precisely our concern over the quasi-criminal nature of civil RICO proceedings (and hence, the need for exclusive Article III elaboration of standards of liability and procedural protections) that distinguishes our analysis from that of the Second Circuit in *McMahon*, *supra*. The Fifth Circuit's apparent solution to the problem — i.e., determining whether the particular action *sub judice* involves arguably criminal or organized crime activity — is in our view unsatisfactory. The makings of a 'pattern of racketeering activity' are not yet clear, but the fact remains that a 'pattern' for civil purposes is a 'pattern' for criminal purposes. 18 U.S.C. §§ 1961(1), 1962, 1964(c). This overlap, in our view, compels the inference that Congress intended only the courts, and not arbitrators, to decide the myraid [sic] of issues that will arise in determining the bounds of liability under the civil RICO statute."

Page v. Moseley, *supra*, ____ F.2d at ____ n.13, [Current] Fed.Sec.L.Rep. (CCH) ¶93,001 at 94,915-94,916 n.13.

A judicial inference of congressional intent to bar arbitration of RICO claims is thus warranted and wholly consistent with the statute's express, quasi-criminal remedy and grant of federal court jurisdiction.

B. Public Policy Considerations Bar the Arbitration of RICO Claims

The federal legislative policy underlying the civil RICO remedy can best be developed in the courts, where the private litigant has the procedural safeguards of judical fact-finding,

the rules of procedure and evidence that do not apply in the typical arbitration proceeding, the benefit of a complete record, additional safeguards of appellate review of RICO decisions, judicial expertise in interpreting and developing the law of a statutorily created cause of action, in this case embodied in a relatively new statute, and the deterrent effect of enforcing RICO by judicial injunction and decision to protect the public interest. Such a course has been set by the Court previously, despite the general federal policy favoring arbitration, and even in the absence of statutory antiwaiver provisions. *See generally McDonald v. City of West Branch, Michigan*, *supra* n.1, 466 U.S. 284; *Barrentine v. Arkansas-Best Freight System, Inc.*, *supra* n.1, 450 U.S. 728; *Alexander v. Gardner-Denver Co.*, *supra* n.1, 415 U.S. 36.

The importance of further interpreting and defining the parameters of this new law makes arbitration of RICO an unacceptable alternative forum. Arbitral panels are not trained in interpreting the complexities and ramifications of RICO, and lack the judicial mandate of issuing findings of fact and conclusions of law and following precedent. RICO thus cannot be fully and fairly evaluated and interpreted because appellate review of arbitration awards is virtually nonexistent. RICO defendants, however, will not be prejudiced by having their cases heard in court rather than in arbitration, since they will thereby be ensured of having their constitutional rights and privileges upheld and will have access to appellate review.

Both the remedial and deterrent function of civil RICO are deprecated by petitioners (Brief on the Merits at 46-49), who surmise that because the majority of RICO suits are merely "commercial disputes that otherwise would involve only claims of breach of contract, securities law violations, or fraud," *id.* at 47, arbitration is not inadequate to resolve such disputes "with no risk to any perceived public policy concerns." *Id.* at 48. This restrictive interpretation of RICO, however, is not supported by the Court's instruction in *Sedima* that RICO must be read and construed broadly "to effectuate its remedial purposes." *Sedima*, *supra*, 105 S.Ct. at 3286.

The importance to the public interest of enforcing RICO in the courts is made even more crucial *especially* where the underlying predicate acts consist of nonarbitrable violations of the securities laws, such as the churning claims at issue. *See, e.g., Tashea v. Bache, Halsey, Stuart, Shields, Inc., supra* n.3, 802 F.2d at 1338-1339. And it is unavailing to petitioners that the deterrent aspect of RICO might only operate concurrently with its private remedial feature, since Congress intended that the civil remedy should work in concert with the former to "enhance the effectiveness of [RICO's] prohibitions."[32]

The intent of Congress and valid public policy concerns advanced by the Second Circuit Court of Appeals are all consistent with the Court's holding in *Mitsubishi*, and justify the finding that agreements to arbitrate RICO claims are unenforceable.

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[32] Hearings on S.30, and Related Proposals, Before Subcommittee No. 5 of the House Committee on the Judiciary, 91st Cong., 2d Sess. 520 (1970).

CONCLUSION

Based upon all the foregoing reasons, the judgment of the United States Court of Appeals for the Second Circuit should be affirmed in all respects.

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